Financial Challenges Ahead: Wall Street Versus Main Street: Deja Vu

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Diversification: we have all been here before

- A utility manager’s desire for flexibility in unregulated energy activities can conflict with “core” customers’ desire for safe, reliable, adequate, and low-cost utility service
- Utility electric and gas utility diversification is not a new problem
- Dates back to 1900 to the PUHCA in 1935

Diversification: *continued*

- The major economic issues raised are:
  - Transfer pricing
  - Cross-subsidization (and cost allocation)
  - The effect of utility subsidiaries or affiliates on:
    - Risk
    - The utility’s return on equity
    - Utility fuel/ purchase power costs
    - Potential synergistic benefits
    - Management expertise
    - Technical innovation

Transfer pricing: we have all been here before

- When a utility and its subsidiary or affiliate engage in business transactions with each other
- The subsidiary or affiliate might charge above-market prices for goods or services, counting on pass-through
- Further complications if the affiliate or subsidiary is outside the state: a problem of access to books and records
- Favoritism by utility toward its subsidiary or affiliate

Cross subsidization: we have all been here before

- Cross-subsidies arise whenever there are joint or common administrative, capital, or operating costs between a utility and its subsidiary and/or affiliate
- Need access to books and records to audit and to perform cost allocation

The effect on risk: we have all been here before

- The relative riskiness of affiliates and subsidiaries has an effect on the perceived riskiness of the utility
- If the utility provides an affiliate supplier with an assured (or likely) customer then the riskiness of the affiliate or subsidiary decreases and the perceived riskiness of the utility could increase (without ring-fencing)

The effect on the utility’s cost of equity: we have all been here before

- Sometime called the double leverage problem
- The utility’s standalone cost of equity cannot be isolated without knowing with certainty about the relative risk of the subsidiaries and affiliates
- Wall street views them as a package, main street wants a clean play (a stand-alone utility ROE)

Effect on fuel/purchase power costs: we have all been here before

- Having the utility available to purchase power is advantageous to the subsidiary /affiliate
- If market prices go up, economic withholding and resale at the higher spot price
- Shifts risks to the utility

Loss of potential synergistic benefits: we have all been here before

- Industrial organizational theory would support vertical integration to reduce transaction costs except to the extent that greater savings could be acquired from competitive suppliers.
- Too much diversification eliminates the cost savings from potential synergies from vertical integration

Reassignment of management expertise: we have all been here before

- The best managers tend to seek out and be assigned to unregulated activities because those activities can produce the greatest profits, which lead to the greatest awards

Technological innovation is corralled: we have all been here before

- Utility expenditures in support of technological innovation will tend to support technological innovation activities of the unregulated subsidiary or affiliate
- Demand side and supply side options will be adopted to favor the activities of the subsidiary or affiliate

Financial abuse: we have all been here before

- Pyramiding, and/or use of utility property or revenue as collateral for loans supporting unregulated activities

Ring fencing: we have all been here before

- State statutes providing for access to books and record
- State statutes to check affiliate transactions
- State statutes to address cross-subsidies
- State statutes to prevent financial abuse
- A divestiture hammer for diversification abuse

Ring fencing - *continued*

- Protects main street customers as well as the wall street investors by eliminating schemes, scams, and machinations from market imperfections.
- Allows for workable competition while protecting traditional, bundled service customers